CHAPTER II

THE LEGISLATIVE HISTORY OF STUDENT LOAN BONDS

The use of student loan bonds was minimal from the mid-1960s to the mid-1970s, became increasingly widespread beginning in the late 1970s, and was subjected to legislative and administrative restrictions in the 1980s.

The low volume of student loan bond issues in the 1960s may have reflected the limited objectives of the GSL program, which initially consisted of insuring commercial lenders against default and providing in-school subsidies to students from families with incomes below $15,000 a year. Virtually all of the lenders in the program were banks, and the interest rates on the loans were set close to the prime rate. In 1969, when interest rates began to rise, the Congress passed the Emergency Insured Student Loan Act, which authorized special allowance payments. These consisted of quarterly payments from the federal government to lenders. The special allowance payments had a statutory ceiling of 3 percent.

Although the first student loan bonds were issued in 1966, few states used them during the next 10 years. The bonds came to the attention of the Congress in 1976, when nonprofit student loan corporations in Texas sought to issue tax-exempt bonds with the assurance that special allowance payments would be excluded from arbitrage calculations. At the time, only six other states had issued student loan bonds. The total volume of issues in 1975 was less than $50 million, and the special allowance had a low (3 percent) ceiling. Members of Congress therefore had little reason to object to the legislation.

The Tax Reform Act of 1976 authorized nonprofit corporations established by a state or local government to issue tax-exempt bonds for the purpose of acquiring GSLs. The act also exempted the special allowance from the provisions of the tax code prohibiting arbitrage. It required that any surpluses that state agencies accumulated either be used to make or purchase additional student loans or be turned over to the state government or a political subdivision.

This and subsequent education legislation provided incentives to establish more student loan authorities and to increase the use of tax-exempt financing. Late in 1976, the Congress raised the ceiling on special

allowance payments to 5 percent and tied them by formula to quarterly changes in the 91-day Treasury bill rate. The Higher Education Technical Amendments of 1979 removed the ceiling completely, making the program more attractive to commercial banks and other lenders and increasing the supply of loans.

In the meantime, the Middle Income Student Assistance Act of 1978 had removed the income limits for in-school interest subsidies on GSLs, greatly expanding the demand for loans. This, in turn, increased the popularity of student loan bonds.

STATE PROFITS ON STUDENT LOAN BONDS

In March 1980, a CBO study reported that the interaction of rising interest rates and tax and education legislation had made it possible for a growing number of state and local governments to accumulate "millions of dollars in unanticipated profits through the federally subsidized guaranteed student loan program."1/ The report pointed out that in 1979 the interest costs of most student loan authorities were below 7 percent, while the yield they received on student loans fluctuated between 11 percent and 16 percent. These spreads of between four and nine percentage points, or more, far exceeded the costs of administering the programs and resulted in windfall profits for the authorities at the federal government's expense.

The Congress may have anticipated the possibility of surpluses, but it had never intended them to be so large. Little, if any, consideration seems to have been given to the effects of higher interest rates. In any event, no one who drafted the tax legislation in 1976 had any reason to anticipate the education legislation that passed a few years later. And, more than likely, the drafters of the education legislation were unaware of the effects it was likely to have on the profitability of the programs.

EFFORTS TO RESTRICT THE USE OF STUDENT LOAN BONDS

When the Congress became aware of the profitability of student loan programs, it passed remedial legislation. The exemption of the special allowance from the arbitrage provisions of the tax code had made it possible for state authorities, which issue bonds at below-market interest

1. Congressional Budget Office, *State Profits on Tax-Exempt Student Loan Bonds: Analysis and Options* (March 1980), p. ix.

rates, to realize a higher return on student loans than commercial banks participating in the GSL program. The Education Amendments of 1980, therefore, reduced by one-half the special allowance rate paid on loans originating from the proceeds of tax-exempt bonds. To assure that student loan authorities were always able to cover their operating costs, the amendments also established minimum special allowances, which vary with the interest rate on the student loan. The minimum allowances are 2.5 percent of the principal for 7 percent GSLs, 1.5 percent for 8 percent loans, and 0.5 percent for 9 percent loans. Loans originated prior to October 1, 1980, when the amendments went into effect, are still eligible for the full special allowance rate.

The Education Amendments also required that authorities submit a formal "plan for doing business" with the Secretary of Education before purchasing or originating GSLs from the proceeds of tax-exempt bonds. Among its requirements, the plan must set the same terms for purchasing loans from all eligible lenders and provide for the development of programs to encourage new lender participation. The Secretary of Education has to approve or disapprove the plan for doing business within 30 days of its submission. Approval is necessary before an agency is eligible to receive the GSL interest subsidy.

The Ford Amendment

The Student Loan Consolidation and Technical Amendments Act of 1983 added to the eligibility requirements for the special allowance payment. It required that an authority's plan for doing business assure that it would issue no more tax-exempt bonds than were necessary to meet "the reasonable needs for student loan credit within the area served by the Authority, after taking into account existing sources of student loan credit in that area." The purpose of the amendment was to assure that authorities issue no more tax-exempt bonds than they could use, both because overissuance can make possible excessive arbitrage profits (see Chapter III) and because tax-exempt financing can result in federal revenue losses (see Chapter IV).

The interpretation of this amendment has been controversial. The Department of Education has interpreted it to mean that unless a state authority has exhausted all possibility of using taxable financing, any loans it makes or purchases with the proceeds of tax-exempt bonds are ineligible for the special allowance payment. The Department based its interpretation on a statement that Congressman William D. Ford, the amendment's sponsor, made during House floor consideration of the act. The purpose of the amendment, he said, was to require scrutiny of "the amounts of capital raised through tax-exempt bonds to insure that excessive amounts beyond

the reasonable needs of student credit are not being sold. The federal revenue forgone because of the tax-exempt status of these bonds increases the...deficit. This...cost should not be incurred beyond...the legitimate educational credit needs of students."2/ The amendment passed both Houses of Congress without committee consideration. The only legislative history on it is in the floor debates, and, apart from Congressman Ford, no one commented on it.

The Department of Education issued proposed regulations implementing the amendment in February 1984 and final regulations one year later.3/ These require an authority to conduct a survey of all available credit, including Sallie Mae and other sources of taxable loan funds, and to conclude that the credit is insufficient to meet the reasonable needs of students in the area before issuing tax-exempt student loan bonds.

The regulations specifically set forth the means for determining the availability of alternative taxable financing, including the assumptions that authorities must use in evaluating their own ability to afford the terms of credit on a taxable borrowing. Sallie Mae, which was established to increase the availability of student loans by providing funds and a secondary market to lenders, is the chief source of taxable financing.4/ The authority must determine the terms on which credit would be available from Sallie Mae and two other lending institutions. If it cannot meet the terms, it must make a good faith effort to negotiate changes that would make taxable financing possible.

Although the Department of Education has no direct control over a state authority's ability to issue tax-exempt bonds, its ability to withhold special allowance payments effectively gives it such control. Following publication of its preliminary regulations, several Members of Congress expressed the view that the requirements for approval of tax-exempt

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2. *Congressional Record*, August 1, 1983, p. H6121. In subsequent correspondence with the Department of Education, Congressman Ford urged against subjecting state and local authorities to "unrealistic," "overzealous," or "unnecessarily burdensome" regulations. This correspondence followed publication of the Department's preliminary regulations implementing the amendment. See letter from Congressman William D. Ford to the Honorable Terrell Bell, Secretary of the U.S. Department of Education, March 8, 1984.

3. See *Federal Register*, vol. 50, no. 27 (February 8, 1985), pp. 5506-5541.

4. Sallie Mae is usually able to offer better terms than commercial banks because it is able to borrow funds at much lower interest rates. See Congressional Budget Office, *Government-Sponsored Enterprises and Their Implicit Federal Subsidy: The Case of Sallie Mae* (December 1985).

financing went beyond the legislative intent of the Ford Amendment. In a letter to Senator Robert Dole, then Chairman of the Committee on Finance, several senators declared that Congress's objective in enacting the amendment "was to avoid excessive issuance of tax-exempt obligations for student loan(s)...not to prevent the issuance of student loan bonds where the need is reasonable or to require issuers to finance their student loan program through the issuance of taxable obligations. The Education Department's proposed regulations go far beyond this objective," they asserted.5/

Paul Simon, Chairman of the House Subcommittee on Postsecondary Education when the Ford Amendment was adopted, held similar views. In a letter to the Secretary of Education, he wrote: "For some time now, both the Treasury Department and the Office of Management and Budget have been urging the Congress to eliminate tax-exempt state bonding authority in a number of areas...in order to reduce revenue losses....I generally support the Administration view....The point...is that Congress has not yet decided the larger question." He added that nowhere in the Ford Amendment language or in the legislative history could support be found for the requirement that state authorities not only demonstrate a need for funds, but also show that taxable financing is infeasible.

For all practical purposes, the Department of Education's interpretation of the Ford Amendment has prevailed. Since its passage, the Department has approved less than half--45 percent--of the $5.9 billion worth of requests from state student loan authorities for tax-exempt financing. At hearings in June 1985, Congressman Ford stated that the Department was carrying its enforcement of the amendment "to the ridiculous."6/ Six months later, the House passed legislation reauthorizing the Education Act of 1965 (H.R. 3700). The bill contains a provision transferring from the Department of Education to the governors of the states the responsibility for approving state authorities' plans for doing business, including assuring against excessive issues of tax-exempt student loan bonds. The reauthorization bill passed by the Senate (S. 1965) in June 1986 goes even further, completely eliminating the requirement to develop a plan for doing business.

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5. Letter from Senators Larry Pressler, Walter Huddleston, John Warner, John Stennis, Edward Zorinsky, Thad Cochran, Mark Andrews, James Exon, Dave Durenberger, and Rudy Boschwitz to Senator Robert Dole, April 25, 1984.

6. Letter from then Congressman now Senator Paul Simon to Secretary of Education Terrell H. Bell, January 30, 1984.

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The Deficit Reduction Act of 1984

At present, the Department of Education exerts the primary, but not the only, control on the use of student loan bonds. The Deficit Reduction Act further restricts use of the bonds. The act imposes a limit on the total volume of student loan and most industrial development bonds that state and local governments may issue.7/ A single overall limit applies to both types of bonds. The limit applies to each state and currently is set at $150 for each resident of the state or $200 million, whichever is greater.8/ So long as the volume of issues is within its limit, a state can determine for itself how to allocate tax-exempt financing. As of the end of 1985, most, but not all states were issuing bonds within the mandated limits. In the future, the volume caps are likely to be more constraining and to force more choices. The Deficit Reduction Act also generally denies tax-exemption to bonds that are backed directly or indirectly by federal guarantees. By virtue of a special exception to the general rule, student loans made with the proceeds of tax-exempt bonds continue to have the same guarantees against default, death, bankruptcy, and disability as loans made from taxable sources of financing.

ARBITRAGE REGULATIONS GOVERNING STUDENT LOAN BONDS

Under current law, student loan bonds are exempt from some of the arbitrage provisions that apply to other tax-exempt bonds. The Deficit Reduction Act, however, tightened the arbitrage provisions on industrial development bonds and opened the way for similar treatment of student loan bonds in the future.

An arbitrage bond is a municipal bond that is used to make a profitable investment. The profit comes from the investment of the proceeds of tax-exempt bonds in higher-yielding taxable securities. In 1969, the Congress enacted legislation to keep arbitrage bonds off the market.

Permissible arbitrage generally is limited so that the spread between the yield on bonds and the yield on acquired obligations is no greater than 0.125 percentage points. If, however, the obligations acquired with the proceeds of the bonds fulfill the purpose of a governmental program, such as student loans, the permissible yield spread is 1.5 percentage points, plus

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7. *The Chronicle of Higher Education* (June 19, 1985), p. 19.

8. Industrial development bonds are tax-exempt bonds issued by state and local governments to provide low-cost financing for private firms.

reasonable administrative costs. These include the costs of issuing the bonds and the underwriter's discount.

Unlimited arbitrage is permitted on proceeds invested for a temporary period prior to use. Generally, this period may not exceed three years. Unlimited arbitrage is also permitted on proceeds invested in a reserve or replacement fund. No more than 15 percent of a bond issue may be invested without regard to yield restrictions, however. Any amounts in a reserve fund are applied against the 15 percent limit.

Under current law, some types of tax-exempt bonds are subject to additional restrictions. The Mortgage Subsidy Bond Tax Act of 1980 imposed special arbitrage requirements on mortgage bonds.9/ The Deficit Reduction Act put similar restrictions on industrial development bonds. The restrictions are noteworthy because of their potential applicability to student loan bonds.

IDB Arbitrage Restrictions

The Deficit Reduction Act required that arbitrage profits earned on "nonpurpose" obligations acquired with the gross proceeds of IDBs be rebated to the United States Treasury. Nonpurpose obligations generally include all obligations other than those specifically acquired to carry out the purpose for which the bonds were issued. Obligations invested in a debt service reserve fund are considered nonpurpose obligations. Gross proceeds include the original proceeds of the bonds, the investment return on obligations acquired with the bond proceeds, and amounts used or available to pay debt service on the issue.

Arbitrage profits that must be rebated include (1) the excess of the aggregate amount earned on all nonpurpose obligations over the amount that would have been earned if all nonpurpose obligations were invested at a rate equal to the yield on the issue, and (2) any income earned on the arbitrage. In determining the amount of arbitrage profits, no costs associated with the nonpurpose obligations or the bond issue itself are considered. The determination is made without regard to issuance costs or underwriters' discount. Ninety percent of the rebate required on any issue must be paid at least once every five years; the balance is due 30 days after retirement of the issue. The rebate requirement does not apply to an issue if all gross

9. The limit will decrease to $100 after December 31, 1986, when the use of small issues of IDBs for nonmanufacturing purposes will no longer be permissible.

proceeds of the issue are expended within six months of the issue date and for the governmental purpose for which the bonds were issued.

The amount of bond proceeds that may be invested in nonpurpose obligations at a yield above the bond yield at any time during the bond year is restricted to 150 percent of the debt service for the bond year. These investments must be reduced as the bond issue is repaid. This restriction does not apply to amounts invested for the initial temporary periods permitted under present law. The rebate requirement will apply, however, to such amounts if the gross proceeds are not expended for the governmental purpose within six months.10/

Arbitrage Restrictions on Student Loan Bonds

The current arbitrage restrictions on student loan bonds are much more lenient than those on IDBs. Current law generally limits permissible arbitrage on student loan bonds to a spread between the interest on the bonds and the interest on the acquired program obligations equal to the greater of (a) 1.5 percentage points plus reasonable administrative costs or (b) all reasonable direct costs of the loan program, including issuance costs and bad debt losses. Special allowance payments made by the Department of Education are not taken into account in determining yield on student loan bonds. In addition, no arbitrage limits are imposed on earnings on nonpurpose obligations for temporary periods of up to three years or on proceeds invested in a reserve fund.

The Deficit Reduction Act directs both the Congressional Budget Office and the General Accounting Office to examine in separate studies the arbitrage treatment of student loan bonds and to make recommendations to the Congress on the appropriate arbitrage restrictions that should apply to student loan bonds. The act specifies that the Congress may then adopt new arbitrage restrictions. If it does not, the Treasury Department has the authority to issue new regulations. This authority includes, but is not limited to, imposing on student loan bonds restrictions similar to those adopted for IDBs; eliminating the special treatment for special allowance payments; and determining that the statutory exceptions for earnings during certain temporary periods and for earnings on reasonably required reserve funds no longer apply to student loan bonds. If the Congress does not enact new rules, the Treasury regulations will become effective on the later of (1) the date that is six months after the regulations are proposed, or (2) the

10. State and local governments issue tax-exempt mortgage bonds to provide low-cost financing for one- to four-family homes.

date that the Higher Education Act of 1965 is reauthorized (or expires, if earlier).

New regulations may or may not ever go into effect. In the meantime, the Department of Education has imposed restrictions that to some extent limit arbitrage earnings from tax-exempt student loan bonds. If the Department determines that loans made with the proceeds of tax-exempt bonds would be eligible for special allowance payments, the bond issue must conform to the following requirements:

- The bond use period must begin within six months of issuance;
- Authorities must use the proceeds of a refunding issue within 30 days of the issue date to retire prior obligations; and
- The bond use period is limited to one year if the proceeds are to be used for making loans and to two years if the proceeds are for buying loans. Any funds unexpended at the end of the period must be used to repay the obligations comprising that issue, unless the authority can demonstrate an unmet need. Previously, the limit was three years.

Pending Tax Legislation

At present, the Congress is considering legislation that would further affect tax-exempt student loan financing. In December 1985, the House of Representatives passed a tax reform bill (H.R. 3838) that includes provisions to impose tighter volume limits and new arbitrage restrictions on student loan bonds. The bill extends to all tax-exempt bonds some of the arbitrage restrictions now applicable to IDBs (see Chapter V for details). It also retains the provision in the Deficit Reduction Act authorizing the Treasury investments during temporary periods and on reserve funds. In June 1986, the Senate passed a tax reform bill that imposes less stringent arbitrage limits on student loan bonds than the House bill and essentially retains the more liberal volume limits in current law. A House-Senate conference will reconcile the differences between these bills.

The potential effect of more stringent measures on tax-exempt financing depends partially on the operations of student loan bond authorities under current law. The following chapter examines the practices and profits of student loan bond issuers.

CHAPTER III

STUDENT LOAN AUTHORITY OPERATIONS

When state authorities issue tax-exempt student loan bonds, they borrow money from bond purchasers and either relend it to students or purchase loans that banks have made to students. In both cases, the authorities receive a stream of interest and principal payments from the federal government and the students, and they use the funds to pay the interest and principal they owe the bondholders. The federal government's interest payments include both the special allowance payment and the interest on the loan while the student is in school.

The participants in student loan bond programs include the agencies that issue the bonds and administer the programs; the students who receive loans from the agencies; the commercial banks and thrift institutions that make loans to students and resell them to state authorities; the Student Loan Marketing Association (Sallie Mae), which buys loans from commercial banks, savings and loans, and some state authorities, and makes loans to these institutions; the investors who purchase the bonds; and the federal government, which subsidizes the programs and currently determines whether loans made or purchased with tax-exempt bonds are eligible for the special allowance. Since the beginning of 1980, the number of state and local authorities issuing tax-exempt student loan bonds has more than doubled.

At present, 54 authorities in 39 states, the District of Columbia, and Puerto Rico issue tax-exempt bonds to finance guaranteed student loans. Of these, 12 are direct lenders, 38 are secondary market purchasers, and four are both direct lenders and secondary market purchasers. The secondary market purchasers buy loans that other financial institutions have originated, thus providing liquid capital to program lenders, who may then make additional loans. The bondholders are primarily commercial banks, casualty insurance companies, and individual investors in high-income brackets who hold bonds either directly or through tax-exempt bond funds.

Of the total number of authorities, 16 are state agencies; the remainder are private, nonprofit organizations that operate at the state or local level. A few states have no student loan authority and rely solely on banks and thrift institutions to provide guaranteed student loans. In Texas, on the other hand, one statewide agency makes direct loans, and 10 regional authorities purchase loans. The level of state supervision over the activities of these authorities varies considerably. Some authorities operate fairly autonomously, while others are under the control of state guaranty agencies that are, in turn, fully accountable to the legislature and governor. Some authorities are required to solicit competitive bids from underwriters before issuing bonds; others may or may not do so.

As of September 30, 1985, state authorities accounted for nearly $4.3 billion of all outstanding GSLs, or about 12 percent of the $39 billion total. The authorities operating direct loan programs held $1.9 billion in student loans, or about 5 percent of the total outstanding at the time. State authorities in Michigan, Minnesota, New Mexico, North Carolina, Texas, Virginia, and Wisconsin account for nearly 80 percent of the loans held by direct lenders who issue tax-exempt bonds.

State secondary markets held $2.4 billion in GSLs as of the end of fiscal year 1985, or nearly 7 percent of all outstanding loans. State secondary markets in California, Colorado, Indiana, Kentucky, Nebraska, North Dakota, and South Dakota held nearly two-thirds of these loans. The largest single purchaser of loans on the secondary market was Sallie Mae, which accounted for 16.1 percent of total holdings of outstanding loans.

The practices of state student loan bond programs vary. Some state authorities make direct loans to students and maintain in-house loan application processing offices. Students may pick up application forms from their student aid offices but must apply directly to the state lending agency for a loan. Other state authorities contract with private lending institutions to process loan applications and make loans to students. The student applies to a bank, and as soon as a loan is made, the bank sells the loan to the state authority. State authorities involved only in secondary market purchases never get involved in loan originations.

OPERATING COSTS

The costs of operating student loan programs depend on the type of activity an authority undertakes, its age, the total amount of loans in its portfolio, the average size of each account, the overall maturity of its

portfolio, and the delinquency and default rates of the loans. Apart from the costs of issuing bonds, which minimally include legal fees and underwriters' discounts, the primary costs of operating student loan programs involve servicing--collecting interest and principal on loans--and general administrative expenses.

In servicing loans, state authorities sometimes contract with private lenders or servicing companies. Collecting interest and principal on student loans is more expensive than on other types of loans. This is because the average size of a student loan ($2,300) is small in comparison to other loans, and the cost of servicing a loan is much the same, regardless of size. Moreover, the average term of a student loan (10 years) is long compared with other small loans, and keeping track of mobile students and recent graduates over so many years is difficult and expensive. The annual cost of servicing student loans generally ranges between 1.25 percent and 1.50 percent of the outstanding loan balance. By comparison, the cost of servicing home mortgages generally runs between 0.25 percent and 0.375 percent of the outstanding balance. Some student loan programs, such as the Illinois State Scholarship Commission, purchase loans that are "damaged," or difficult to collect. These loans, of course, are even more expensive to service.

Between 1980 and 1984, the Higher Education Loan Programs (HELP), which operate in Washington, D.C., Kansas, and West Virginia, had servicing costs ranging from 0.5 percent to 2.5 percent of average outstanding loan volume. In 1984, servicing costs for each of the agencies were 0.8 percent in Washington, D.C., 1.3 percent in Kansas, and 1.5 percent in West Virginia, which had a much smaller portfolio of outstanding loans than either of the other two agencies.1/ The Virginia Educational Loan Authority has servicing costs ranging between 1.0 percent and 1.25 percent of outstanding loan volume. All of these agencies operate direct loan programs. Although exceptions abound, generally the relative cost of servicing declines as the size of the loan portfolio increases.

The same holds for administrative costs, which include personnel, staffing, office space, and other expenses associated with issuing bonds, and

1. This information was provided to CBO by the Higher Education Management and Resources (HEMAR) group. The group includes the Higher Education Assistance Foundation (HAEF), which serves as the primary guarantor of student loans in six states and provides loan guarantees and related services nationwide; the Higher Education Loan Programs (HELP) of Kansas, Washington, D.C., and West Virginia; and the HEMAR Service Corporation (HSC).

making and purchasing loans. Authorities that originate loans are likely to have relatively higher administrative costs than those that purchase them on the secondary market. On the other hand, their servicing costs may be relatively lower because of the period of time that elapses before the loans go into repayment. In general, the higher the proportion of loans in repayment, the greater the servicing costs as a percentage of total outstanding loans. The age of an agency will also determine the relative cost of administration, with start-up costs generally representing a much larger percentage of total outstanding loans than ongoing expenses.

Some authorities originate loans and sell them to Sallie Mae, while others hold them to maturity. The sale of loans reduces the total value of the originating authority's portfolio, without reducing general administrative expenses. As a result, these will go up as a percentage of the authority's total outstanding loans.

Between 1980 and 1984, the administrative costs of the three HELP programs ranged from 0.5 percent to 5.3 percent. In 1984, the combined administrative and servicing costs of each of the three programs were 2.1 percent of outstanding loans in Kansas, 2.3 percent in Washington, D.C., and 4.4 percent in West Virginia. The latter had a loan portfolio of slightly more than $1 million, while the other agencies' portfolios each exceeded $50 million.

At present, a well established, efficient agency with a sizable portfolio of loans is generally able to keep total operating costs down to between 2.0 percent and 2.5 percent of outstanding loan principal over the long term. Some do better; others not as well.

THE YIELD ON STUDENT LOANS

The interest rates that student loan recipients are paying may be 7, 8, or 9 percent, depending on when the loan was made. The rate for new loans is currently 8 percent. The yield to the lender consists of the student's interest liability on the loan, which is statutory, and the special allowance payments (SAP) made by the Department of Education, which are calculated each quarter to bring the total up to an administratively set "market interest rate." For student loans financed with taxable funds, the total return is 3.5 percentage points above the T-bill rate. For student loans financed with tax-exempt bonds, the special allowance is the greater of one-half of the regular payment, or whatever payment is necessary to

assure a minimum return of 9.5 percent.2/ All loans made or insured before October 1, 1980, are eligible for the full SAP, regardless of whether or not they were financed with tax-exempt bonds. Many of these loans, which carry a 7 percent interest rate, are still outstanding. As they get paid off, they comprise a diminishing proportion of all outstanding loans, but some state authorities, particularly the older ones, still have a number of these highly profitable loans in their portfolios.

RETURNS TO STUDENT LOAN AUTHORITIES

The returns to state and local authorities from operating student loan programs vary with both their cost of funds and Treasury bill rates. The profitability of any program depends on the spread between an authority's borrowing costs, on the one hand, and its interest earnings, on the other. Authorities also have other sources of income, including the interest earned on unobligated bond proceeds, reserve funds, and retained earnings from previous years.

In the late 1970s, some student loan authorities profited from spreads between their interest costs and loan yields of 10 percentage points and more. This was possible because, even though their borrowing costs were roughly 30 percent lower than those of commercial banks, authorities received the same special allowance payment, and the SAP was based on a commercial lender's cost of funds. Typically, authorities had borrowed at fixed rates and for relatively long terms--generally between 10 and 17 years, and less commonly for three years.3/ As interest rates rose, so did loan yields and profits.

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2. For loans financed with tax-exempt bonds, the basic formula for the SAP is 0.5 x [T-bill rate + 3.5 - student loan interest rate]. On 7 percent loans, the SAP is one-half of the bond equivalent T-bill rate minus 3.5, but not less than 2.5 percent; on 8 percent loans, the SAP is equal to one-half of the bond equivalent T-bill rate minus 4.5, but not less than 1.5 percent; and on 9 percent loans, it is one-half of the T-bill rate minus 5.5, but not less than 0.5 percent. This basic formula applies to all loans made since October 1, 1981, and, with slight modifications, to all loans made after October 1, 1980. For loans made between October 1, 1980, and October 1, 1981, the SAP was rounded up to the next one-eighth of 1 percent interest point.

3. The time horizon for long-term bonds has generally been 15-17 years. Students must repay loans 10 years after graduation or 15 years after receiving the loans, whichever is shorter. Loan repayment periods are generally ten years, but deferments can extend the term of the loan up to three years. Moreover, in the past authorities have had up

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With the passage of the Student Loan Act of 1980, which reduced the special allowance for loans financed with tax-exempt bonds, the spreads between interest costs and loan yields narrowed. Under some circumstances, however, student loan authorities can still realize spreads that are much higher than necessary to cover costs. They also are exposed to more interest rate risk than previously, and, accordingly, their methods of financing are much more varied than they were in the late 1970s. If interest rates are favorable (below, say, 8 percent), authorities may issue long-term, fixed-rate bonds. Since they are assured a minimum return on student loans of 9.5 percent, they are protected if interest rates fall and can profit from wide spreads if rates rise.4/ If interest rates are high, authorities are more likely to issue short-term or floating rate bonds.

In the early 1980s, when interest rates were high, student loan authorities tended to issue bonds for three-year terms. This practice has become much less common because three-year bonds have to be refinanced upon maturity and, under current law, refundings of tax-exempt bonds have to receive approval from the Department of Education in order for the SAP to continue. Since authorities would prefer to seek such approval as infrequently as possible, the more common practice currently is to issue long-term (up to 17 years) bonds. These may be fixed-rate term bonds, bonds with serial maturities, variable-rate bonds, or some combination of the three.

Variable/Fixed-Rate Bond Issues

In the past year, several authorities have issued variable-rate bonds that are convertible to fixed-rate instruments. Although the details of these "flexibonds" vary, in general they have increased student loan authorities' ability to borrow when interest rates are high and have enhanced their potential for accumulating surpluses from arbitrage profits. In 1980, when the legislation reducing the special allowance went into effect, fixed-rate financing was the norm. More recently, the pattern has been to issue bonds with rates that may be fixed for a brief period and subsequently adjusted.

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to three years to make or acquire loans. They now have between one and two years, unless they choose to forgo the SAP.

4. The current policies of the agencies that rate student loan bonds also assure wide spreads. The agencies insist that analysis of a proposed bond issue be based on a worst case scenario and that SAP payments be excluded from projections of cash flow.

The adjusted rates may then be variable or fixed for a long term, depending on prevailing interest rate levels. If variable, the bonds will usually have a provision for conversion to a fixed-rate instrument when interest rates drop to a specified level--generally between 7 percent and 8 percent. The rate will vary among authorities, depending on the spread necessary to cover administrative and servicing costs. Once the specified interest rate is reached, the bonds must become fixed-rate instruments. The conditions for conversion are usually specified in detail in the bond documents so that it is automatic and the authority has no further decision to make. This assures that the conversion is considered a repricing of the bond, rather than a refunding, and makes it unnecessary for authorities to seek repeated approvals for the same initial offering.

Interest rates on variable-rate bonds change weekly, making these instruments much like seven-day commercial paper. Consequently, a bank letter of credit is generally necessary to back up any redemptions before the stated maturity date. An independent indexing or remarketing agent sets the weekly rate, which is generally based on the interest index for tax-exempt bonds similar in rating and remaining maturity. The variable rate is set at whatever the indexing or remarketing agent determines is the minimum necessary to resell the bonds at par.5/

In the recent past, authorities have issued several types of flexibonds. The following tables indicate the spreads that would result from a typical variable-rate issue that is convertible to a fixed-rate, long-term bond if interest rates on securities with similar ratings and remaining maturities drop to 7.5 percent. The example is based on assumptions that reflect current market conditions and practices; however, these could change, and the current diversity of student loan bond issues makes conclusions based on any particular example difficult.

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5. For the authorities, variable-rate financing involves some risk because, unlike the yield on student loans, the rate on the bonds is not directly pegged to the T-bill. If the variable-rate tax-exempt bond index rises more rapidly than T-bill rates, the result could be costly to the authorities. On the other hand, if the index falls more rapidly than T-bill rates, authorities can more than cover their costs. A few years ago, some authorities issued variable-rate bonds pegged to the T-bill rate. These had the advantage of locking in a spread; however, the bonds were hard to sell, and they traded poorly on the secondary market. This was because variable-rate tax-exempts are "put" bonds, which means that once a week the issuer must be prepared to redeem them. The bonds, therefore, have to carry a price that makes it possible to sell them at par. If the bonds are pegged to the rate on another security, such as T-bills, they could sell at, above, or below par. Any number of events, such as changes in tax law, could have a marked effect on the relationship between short-term tax-exempt rates and T-bill rates and, therefore, on the value of the securities. Consequently, it is virtually impossible to lock in a spread.

With variable-rate financing, the lower the T-bill rate, the larger the spread between an authority's cost of financing and its return on loans made or insured after October 1, 1980. Because of the guaranteed 9.5 percent yield on student loans financed with tax-exempt bonds, the spreads not only can exceed the amount necessary to cover servicing and operating costs, but at times also can result in excess arbitrage earnings. Under current law, excess arbitrage profits would result if yields on loans--excluding the SAP--exceed the interest on student loan bonds by more than 1.5 percentage points, plus reasonable administrative costs associated with bond issuance, such as letter of credit or insurance fees. The problem of excess arbitrage is most likely to arise with variable-rate financing when T-bill rates are low because the SAP is then a relatively small portion of the total yield on student loans (see Tables 1 and 2).

To date, the federal government has issued no regulations specifying how authorities should calculate yields on floating-rate bonds for purposes of determining whether or not they are earning excess arbitrage profits. If authorities earn excess arbitrage, their bonds could become taxable. At present, a "reasonable expectations" rule determines whether excess arbitrage has been earned. If an authority earns excess arbitrage, but did not or could not reasonably expect to have done so, no violation has occurred. The problem is that with variable-rate financing, reasonable expectations are hard to define. Accordingly bond counsel are advising authorities to put excess earnings into escrow. In the future, authorities may use excess funds to forgive student loans.

Over the long term, authorities benefit most from fixed-rate financing, not only because the terms of the bonds then match the terms of the loans more closely, but also because excess arbitrage ceases to be a problem. The spreads on fixed-rate bonds increase as interest rates rise. At the same time, the SAP, which is exempt from arbitrage restrictions, becomes an increasingly higher proportion of the loan yield, so that authorities need not be concerned about earning excess arbitrage profits (see Table 3). In other words, whatever their profits, the authorities may keep them.6/ Once an authority locks in a fixed interest rate, it is protected from losses if T-bill rates fall because of the 9.5 percent minimum guaranteed yield on student loans, and it can make substantial profits if T-bill rates rise above 9 percent.

6. If a program closed down, however, profits would go to the state or a political subdivision.

TABLE 1. STATE AUTHORITY SPREADS ON 8 PERCENT STUDENT LOANS FINANCED WITH VARIABLE-RATE BONDS UNDER CURRENT LAW

T-Bill Rate	Cost of Funds[a]	SAP[b]	Return on 8 Percent Loans[c]	Spread[d]	Maximum Permissible Spread[e]
5.0	5.50	1.50	9.50	4.00	3.00
6.0	5.50	1.50	9.50	4.00	3.00
7.0	5.50	1.50	9.50	4.00	3.00
8.0	5.50	1.75	9.75	4.25	3.25
9.0	5.63	2.25	10.25	4.62	3.75
10.0	6.25	2.75	10.75	4.50	4.25
11.0	6.88	3.25	11.25	4.37	4.75
12.0	7.50	3.75	11.75	4.25	5.25
13.0	8.13	4.25	12.25	4.12	5.75
14.0	8.75	4.75	12.75	4.00	6.25
15.0	9.38	5.25	13.25	3.87	6.75

SOURCE: Congressional Budget Office.

a. Assumes that on average the weekly variable rate will be 62.5 percent of the T-bill rate, but not less than 5.5 percent. Some bond issues have interest rate floors; others do not. Interest rates change weekly and reflect the price necessary to remarket the bonds at par. The relationship of this price to the T-bill rate will fluctuate. Two indexes of short-term tax-exempt interest rates that have been used to set prices for variable-rate student loan bonds are the Kenny Index and the Banker's Trust Tax-Exempt Note Rate (TENR). A few years ago, variable-rate student loan bonds were frequently priced at TENR plus between 0.25 and 0.50 percentage points. The average of the ratio for the Kenny Index to the T-bill from January 1984 to June 1985 and TENR + 0.375 percentage points to the T-bill from January 1982 to June 1985 was 62.5 percent. Variable and short-term municipal rates generally have been between 55 percent and 70 percent of rates on taxable money market instruments. The cost of funds does not include letter of credit fees, which range from 0.375 percent to 0.875 percent a year, or other administrative costs associated with bond issuance. On average, letter of credit fees alone would reduce spreads by about 0.625 percentage points a year.

b. The special allowance payment (SAP) = [T-bill - 4.5] percent x 0.5, but not less than 1.5 percent.

c. The return on loans is the borrower's interest payment plus the SAP, but is not less than 9.5 percent.

d. Without an interest rate floor, the spreads at lower T-bill rates would be 6.37 percentage points when the T-bill is 5 percent; 5.75 when the T-bill is 6 percent; 5.12 when the T-bill is 7 percent; and 4.75 when the T-bill is 8 percent. These spreads would result in substantial excess arbitrage profits.

e. The maximum permissible spread is equal to the SAP plus 1.5 percentage points. Where the maximum permissible spread is less than the actual spread, the difference, minus letter of credit and other fees associated with bond issuance, represents excess arbitrage profits that, if kept, might jeopardize tax-exemption of the bonds. If the actual spread is smaller than or equal to the maximum, then the authorities are operating within the arbitrage provisions of current law.

TABLE 2. STATE AUTHORITY SPREADS AND MAXIMUM PERMISSIBLE SPREADS UNDER CURRENT ARBITRAGE REGULATIONS ON 7, 8, AND 9 PERCENT STUDENT LOANS FINANCED WITH VARIABLE-RATE BONDS[a,b,c]

T-Bill Rate	Pre-October 1, 1980, 7 Percent Loans		Post-October 1, 1980, Loans					
	Spread	Maximum Spread	7 Percent Spread	Maximum Spread	8 Percent Spread	Maximum Spread	9 Percent Spread	Maximum Spread
5.0	5.37	3.00	6.37	4.00	6.37	3.00	6.37	2.00
6.0	5.75	4.00	5.75	4.00	5.75	3.00	5.75	2.00
7.0	6.12	5.00	5.12	4.00	5.12	3.00	5.37	2.25
8.0	6.50	6.00	4.50	4.00	4.75	3.25	5.25	2.75
9.0	6.87	7.00	4.12	4.25	4.62	3.75	5.12	3.25
10.0	7.25	8.00	4.00	4.75	4.50	4.25	5.00	3.75
11.0	7.62	4.00	3.87	5.25	4.37	4.75	4.87	4.25
12.0	8.00	10.00	3.75	5.75	4.25	5.25	4.75	4.75
13.0	8.37	11.00	3.62	6.25	4.12	5.75	4.62	5.25
14.0	8.75	12.00	3.50	6.75	4.00	6.25	4.50	5.75
15.0	9.12	13.00	3.37	7.25	3.87	6.75	4.37	6.25

SOURCE: Congressional Budget Office.

a. Assumes that the authorities' cost of funds will average 62.5 percent of T-Bill rates. This does not include letter of credit fees, which range between 0.375 percent and 0.875 percent a year, or other administrative costs associated with bond issuance.

b. Spreads are based on the current formula for calculating the special allowance payment. The SAP on loans originated between October 1, 1980, and October 1, 1981, is rounded up to the nearest 1/8 of 1 percent. Loans made before October 1, 1980, are eligible for the full SAP.

c. Under current law, the maximum permissible spread is equal to the SAP plus 1.5 percentage points. Where the maximum permissible spread is less than the actual spread, the difference, minus letter of credit and other fees, represents excess arbitrage profits that, if kept, might jeopardize tax-exemption of the bonds. The problem does not arise if the actual spread is equal to or smaller than the maximum.